

# Appendix #11

G. Cornia, D. Sjoquist and L. Walters, Study  
on Voluntary Sales Tax Compliance

# Sales and Use Tax Simplification and Voluntary Compliance

GARY C. CORNIA, DAVID L. SJOQUIST, and LAWRENCE C. WALTERS

---

Because of difficulties collecting sales taxes on Internet sales, several states have engaged in an effort (the Streamlined Sales Tax Project, SSTP) to simplify their sales tax systems. One hope among SSTP proponents is that a simplified system will result in Internet vendors voluntarily collecting the sales tax. We address two issues:

- Will states adopt the extensive reforms proposed by the SSTP?
- Will vendors voluntarily collect the sales tax?

We argue that states are unlikely to adopt extensive reforms, but if they did, many vendors would voluntarily collect sales taxes.

## INTRODUCTION

For the past four decades a variety of actors, including the U.S. Congress, federal agencies, governors, revenue departments, legislative bodies, and numerous public and business interest groups, have engaged in a series of negotiations, studies, administrative compacts, and court battles concerning the collection of the use tax.<sup>1</sup> The use tax, a companion to the sales tax, is imposed on a good or service that is consumed within the state when the full sales tax on the item has not been collected.<sup>2</sup> A major difference

---

Gary C. Cornia is Stewart Grow Professor of Public Management, Romney Institute of Public Management, Marriott School of Management, Brigham Young University, Provo, UT 84602, and is the current president of the National Tax Association. He can be reached at [gcc2@email.byu.edu](mailto:gcc2@email.byu.edu).

David L. Sjoquist is Professor of Economics, holder of the Dan E. Sweat Distinguished Scholar Chair in Educational and Community Policy, and Director of the Fiscal Research Center, Andrew Young School of Policy Studies, Georgia State University, Atlanta, GA 30303. He can be reached at [sjoquist@gsu.edu](mailto:sjoquist@gsu.edu).

Lawrence C. Walters is Masters of Public Administration Director and Associate Professor of Public Policy and Management, George Mason University, Fairfax, VA. He is currently Visiting Senior Fellow at the Lincoln Institute of Land Policy, Cambridge, MA 02138. He can be reached at [lwalters@lincolninst.edu](mailto:lwalters@lincolninst.edu).

1. Kendall L. Houghton and Gary C. Cornia, "The National Tax Association's Project on Electronic Commerce and Telecommunication Taxes," *National Tax Journal* 53, no. 4 (2000): 1351–1373.

2. John F. Due and John L. Mikesell, *Sales Taxation* (Washington, DC: Urban Institute Press, 1994).

between the two taxes concerns who is responsible for collecting the tax. While states can require in-state vendors to collect the sales tax, they are unable to impose a similar compliance and collection requirement on out-of-state (remote) vendors. Thus, the use tax is designed to be directly collected from retail consumers. This has proven extremely difficult, in part because most taxpayers simply have no idea that they owe the use tax.<sup>3</sup>

Because of the difficulty of collecting the use tax from the consumer, states have made various (unsuccessful) attempts to require remote vendors to collect the sales tax. Currently, several states are engaged in an effort, known as the Streamlined Sales Tax Project (SSTP), to simplify their sales and use tax systems in order to reduce the burden of collection for all sellers and create a collection system for remote sellers.<sup>4</sup> One hope among SSTP proponents is that a simplified system will result in remote vendors voluntarily collecting the sales tax.

In this article we address two major issues. First, we discuss the challenges states face as they try to implement a common simplification of their sales and use tax systems. We conclude that states will adopt many of the changes specified by the SSTP, but there is a serious question whether the changes to their sales and use tax structures will be as substantial as many of the remote retailers and leaders of the SSTP want. Second, we consider the question of whether vendors will voluntarily collect use taxes. In doing so, we review motivations and concerns that firms may face as they consider voluntary compliance with the use tax and offer an initial analysis of the likelihood of voluntary compliance based on a simulation model. The results suggest that voluntary compliance, under certain conditions, may occur with some frequency. The simulations suggest the states participating in the SSTP process have much to gain by simplifying their sales and use tax systems.

## BACKGROUND

Before discussing the two main issues, we provide some background on the efforts to require collection of the use tax. The most notable events in the long saga to collect the use tax have been Supreme Court decisions. On two separate occasions, *National Bellas Hess, Inc. v. Illinois Department of Revenue*<sup>5</sup> and *Quill Corporation v. North Dakota*,<sup>6</sup> the United States Supreme Court has sided with the nontraditional vendors and ruled that they could not be compelled to collect the use tax. In the *National Bellas Hess* case, the Court reasoned that unless a firm has a physical presence in a state, that is, a physical

---

3. Sally M. Jones, *Principles of Taxation for Business and Investment Planning* (New York: McGraw-Hill, 2002).

4. Graham Williams, "Update on the Streamlined Sales Tax Implementing States," NCSL, available from: <http://www.ncsl.org/programs/press/2002/implementstates.htm>, June 2002; last accessed 3 December 2003.

5. *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753, 1967.

6. *Quill Corporation v. North Dakota*, 112 S. Ct. 1904, decided 26 May 1992.

*nexus*, forcing it to collect the use tax would violate due process protection and the commerce clause. In the more recent *Quill* case, the Court retained the nexus test; however, the Court concluded that due process would not be violated if compliance requirements were imposed. The Court indicated that Congress could resolve the issues with respect to the commerce clause; however, Congress has considered this matter on multiple occasions but has failed to act.<sup>7</sup>

States have pushed for use tax collection for two major reasons. First, the inability to collect the use tax has generated concerns over the loss of tax revenue, concerns that initially focused on catalog or mail order sales, and then in the late 1990s on e-commerce.<sup>8</sup> While estimates of revenue loss from mail order catalog companies<sup>9</sup> and early estimates of revenue loss from e-commerce are very modest,<sup>10</sup> more recently Bruce and Fox<sup>11</sup> found that state and local governments could expect to face sizable reductions in sales and use tax revenues.<sup>12</sup> Cornia et al.<sup>13</sup> report that the problems associated with the use tax could undermine the ability of local governments to support some public debt issues that are funded by local option sales and use taxes.

The second reason that state public officials support the collection of the use tax is that the current system creates an uneven playing field between traditional and remote vendors. Collecting the sales tax from some vendors but not collecting the use tax from remote vendors selling similar goods and services violates the basic tax principle of horizontal equity. Having lost at the Supreme Court and unable to construct an acceptable congressional response, state officials have embarked on a considerably different path to facilitate collecting the use tax. In 1999, a group of state leaders,

---

7. Walter Hellerstein, "Transaction Taxes and Electronic Commerce: Designing State Taxes that Work in an Interstate Environment," *National Tax Journal* 55, no. 3 (1997): 593–606; and Ferdinand P. Schoettler, *State and Local Taxation: The Law and Policy of Multi-Jurisdictional Taxation* (Newark, NJ: LexisNexis, 2003) offer reviews on the legal issues around the challenges of determining nexus.

8. Donald Bruce, William Fox, and Mathew Murray, *To Tax or Not to Tax? The Case of Electronic Commerce* (Knoxville, TN: Center for Business and Economic Research, University of Tennessee, 2001).

9. Advisory Commission on Intergovernmental Relations (ACIR), *State and Local Taxation of Out-of-State Mail Order Sales* (Washington, DC: ACIR, 1986).

10. Robert J. Cline and Thomas S. Neubig, "The Sky Is Not Falling: Why State and Local Tax Revenues Were Not Significantly Impacted by the Internet in 1998," *State Tax Notes* 17, no. 1 (1999): 43–51.

11. Donald Bruce and William F. Fox, "E-Commerce in the Context of Declining State Sales Tax Bases," *National Tax Journal* 53, no. 4, part 3 (2000): 1373–1388; and Donald Bruce and William F. Fox, *State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates* (Knoxville, TN: Center for Business and Economic Research, University of Tennessee, 2001).

12. A key assumption of the work by Bruce and Fox is that a substantial portion of the business-to-business (B2B) use tax goes uncollected. Austan Goolsbee, "In a World without Borders: The Impact of Taxes on Internet Commerce," in *The Internet Upheaval: Raising Questions, Seeking Answers in Communications Policy*, eds. Ingo Vogelsang and Benjamin M. Compaine (Cambridge and London: MIT Press, 2000), 29–46, questions this assumption.

13. Gary C. Cornia et al. "E-Commerce and the Single-Rate Sales Tax Proposal," *Municipal Finance Journal* 22, no. 3 (2001): 1–23.

acknowledging that the complaints raised by vendors about the expense and burden of use tax compliance had validity, initiated the SSTP, with the objective to standardize and simplify their sales and use tax systems, thus reducing the compliance burden for remote vendors. To date, the District of Columbia and 38 of the 45 states with a sales tax have joined the effort. In November 2002, the SSTP representative of 33 states ratified an agreement that specified the changes in sales and use tax systems that will be required of a state to be in compliance with the SSTP. The agreement requires the following: Each state will adopt a state-level administrative process, implement a common tax base, and provide a transparent system to notify vendors of rate and base changes. The agreement also has a uniform rule for sourcing nontraditional sales and telecommunication fees and taxes. A number of administrative agreements were also adopted, such as the uniform and simplified treatment of exemptions, a single return filed in each state, and the uniform recovery of bad debts.

States will still have to pass legislation to make the actual changes to their sales and use tax systems. An important question is whether states will be willing to make these changes. Part of the motivation for the SSTP is the hope that simplifying the sales and use tax system would either induce Congress to adopt legislation requiring remote vendors to collect the use tax or convince the Supreme Court to rule in the states' favor in the next use tax compliance case. However, in our view, the most interesting supposition offered by supporters of the SSTP process is the proposition that by making the process of complying with the use tax straightforward and transparent, remote business to consumer (B2C) vendors and business to business (B2B) vendors will volunteer to collect the sales and use tax.<sup>14</sup> A second important issue is whether remote vendors will voluntarily collect the sales tax.

Thus, we now turn to consideration of the two basic questions:

- Can the states agree on a greatly simplified sales and use tax system?
- Can voluntary compliance succeed?

### **CAN THE STATES PULL IT OFF?**

Creating a sales and use tax process that works in a nonuniform federal system is not a minor undertaking; four decades of trying to resolve the issues is proof of the difficulties. In fact, the growing use of sales tax holidays, equipment exemptions, food exemptions, and local sales taxes have made the sales and use tax more complex and even less uniform across states. Given the November 2002 SSTP agreement, there are three major

---

14. Even without the concerns around use tax, states will likely benefit from sales and use tax simplification. For example, Ali Agha and Jonathan Houghton, "Designing VAT Systems: Some Efficiency Considerations," *The Review of Economics and Statistics* 78, no. 2 (1996): 303–308, report higher VAT compliance in the European countries where rates are lower and tax bases are more uniform.

challenges facing the simplification effort. First, states must find ways to simplify and harmonize the administration of 45 separate and distinct sales and use tax systems. For example, states will have to implement uniform regulations for sales tax registration and payment schedules. Second, states will likely need to make concessions with respect to sales and use tax bases. The goal is for everyone to use similar definitions for goods and services, but not necessarily to have uniform tax bases. But adopting common definitions may well result in tax base changes for many states. Finally, states need to find a way to deal with the thousands of different state and local sales and use tax rates that a national company must understand and comply with.<sup>15</sup> While there has been considerable success in getting states to agree on what a simplified system should be, there remain serious obstacles that must be overcome if the proposed changes are to be implemented by states.<sup>16</sup> We highlight three obstacles—politics, revenue importance, and technology—that may undermine the simplification process.<sup>17</sup>

### *Politics*

Interstate political issues are fraught with complexities. Despite the November 2002 SSTP agreement, no one assumes that among the SSTP member states there is complete agreement on the steps needed to simplify the sales and use tax administrative processes. In general, interstate cooperation is not easy to find, and in fact interstate competition seems to be the rule of the day. On tax issues, states and local governments often openly compete with each other for new and old businesses by offering a variety of tax and fiscal incentives such as general sales tax holidays and industry- or firm-specific sales tax exemptions.<sup>18</sup> Despite repeated calls for a truce on tax base competition, it continues unabated. Even with the November SSTP agreement there is no strong evidence that states will actually be willing to forgo at least some of these policy options by agreeing to more uniformity.

A significant issue is how to deal with the states that are not part of the SSTP effort. The current absence of participation by politically and economically important states such as California, Massachusetts, and New York is a challenge to the SSTP process. In the long run, such states will need to join with the SSTP states, or the SSTP will be seriously compromised. While it does appear that the current fiscal crisis that California

---

15. Gary C. Cornia et al. "An Analysis of the Feasibility of Implementing a Single Rate Sales Tax," *National Tax Journal* 53, no. 4 (2000): 1327–1350.

16. Charles E. McLure, "The Nuttiness of State and Local Taxes," *State Tax Notes* 25, no. 12 (2002): 841–856.

17. The proposals associated with the SSTP project can be found at <http://www.geocities.com/streamlined2000>; last accessed 3 December 2003.

18. Daphne A. Kenyon and John Kincaid, *Competition among States and Local Governments: Efficiency and Equity in American Federalism* (Washington, DC: The Urban Institute Press, 1991); and Wallace E. Oates and Robert M. Schwab, "Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing?" *Journal of Public Economics* 35, no. 3 (1988): 333–354.

is facing has caused a rethinking of the states' position, it is not at all clear that these states will eventually participate in the process. Because of their importance these states have more power, which may make the process of reaching agreement more difficult.

On the positive side, there are instances of multistate cooperation to improve and rationalize state tax systems. The Multistate Tax Commission (MTC) is an example of a compact between states that has facilitated uniformity between the states in terms of audit coverage and administrative performance. Of course, for some members of the business community, the MTC illustrates why cooperative tax administration should be avoided. And within the member states of the MTC there is disagreement over strategy and tactics.<sup>19</sup> The growing number of states that have abandoned the use of a three-factor apportionment formula for state corporate income and moved toward a single factor based on sales is an example of how agreements between states can erode over time. Such moves undermine interstate cooperation in the apportionment of income.<sup>20</sup> The multistate charter on collecting the motor fuel tax from the interstate trucking industry is a recent positive example of efforts to improve the performance of the tax system in 50 states by streamlining the administration of the tax.<sup>21,22</sup> The ability of the participating states to change the sales and use tax also depends on a variety of intrastate political issues. One issue is how state legislative leaders will respond relative to their governor. During the initial planning stages of the SSTP, the National Conference of State Legislators (NCSL) adopted a proposal that was different from the SSTP document that had been drafted by the National Governors Association (NGA), the Federation of Tax Administrators (FTA), and the MTC. The NCSL substitute differed from the NGA proposal in several significant ways: definitions for the sales and use tax base; sourcing (i.e., will the tax be due at the point of purchase or at the point of delivery?); rules for bad debts; and tax rates.<sup>23</sup> In the early stages of the discussions, many of the legislative leaders were unwilling to confront the administrative and policy challenges in the SSTP proposal.

---

19. David Brunori, *The Politics of State Taxation. Now More than Ever MTC Is Needed*, Tax Analysts Reference, 1999 STT 152-28 (3 August, 1999).

20. Kelly D. Edminston, "Strategic Apportionment of the State Corporate Income Tax: An Applied General Equilibrium Analysis," *National Tax Journal* 55, no. 2 (2002): 239-262.

21. Utah State Tax Commission, *International Fuel Tax Agreement* (Salt Lake City: Utah State Tax Commission, 1999).

22. States have shown that when they share a mutual interest, they are willing to cooperate in legal cases before the U.S. Supreme Court. Since the mid-1980s, the states have filed a series of *amicus curiae* briefs with the Court. The briefs are written to reflect the combined position of the participating states. This practice offers evidence that states can cooperate, but it also offers a warning. States generally file briefs only when the issues are narrow and technical. In more complex cases involving issues where policies and politics may differ between the states, the briefs are absent. See Edward B. Lavery and Kenneth T. Palmer, "State and Local Governmental Interest Groups before the Supreme Court: Implications for Intergovernmental Policy," *Public Administration Quarterly* 24, no. 4 (2001): 522-537.

23. Arthur R. Rosen and Susan K. Haffield, *Streamlined Sales Tax Liability Likely to Affect All U.S. Businesses* (New York: McDermott Will and Emery, 2001).

Finally, political party affiliation could be a roadblock. There has been a clear difference between the two national political parties on the issue of taxing sales made over the Internet, as reflected in the votes over the Internet Tax Freedom Act. In the first extension of the Internet Tax Freedom Act, only eight Republican representatives but most Democratic representatives opposed the bill. The vote in the Senate also reflected a bright line distinction between Democrats and Republicans.<sup>24</sup> However, the most visible supporter of the SSTP process has been Mike Leavitt, Republican Governor of Utah.

#### *Importance of Sales Tax Revenue to State and Local Governments*

Fiscal autonomy and the importance of sales tax revenue may have a role in the willingness of a state to compromise its current tax system and conform to the recommendations proposed by the SSTP. State leaders may conclude that the revenue and political implications of change are too drastic or uncertain to be acceptable. Another possibility is that because the sales tax is so important, state leaders will recognize a need to adopt the SSTP proposals to ensure that the revenue from the sales tax will continue. It is also possible that some states will not adopt the proposals, but hope that other states do so. Such states may assume that if a sufficient number of states follow the SSTP proposals, they will eventually benefit from the simplified system without having to engage in the political gamble of participating in the SSTP process.

A key part of any cooperative outcome is the treatment of local governments. In 1999–2000, 12.2 percent of local government tax revenue came from the sales and use tax. The problem is that the local option taxes have created thousands of distinct taxing jurisdictions for which remote sellers must collect the use tax. In some states the number of different local rates exceeds ten, and in eight states the number of local rates exceeds 20. Understandably, local governments are reluctant to agree to any plan that might diminish the importance of revenue from this source of funding. And remote sellers have been quite firm that without some concession on the number of sales tax rates, they will not endorse the SSTP process. Nevertheless, local officials have demonstrated little interest in doing more than is currently being offered. There are also states such as Colorado and Louisiana where sales and use taxes have been collected locally, and local governments in those states were reluctant to grant to their respective state revenue departments the authority to collect the use tax.

Another difficult issue is found in states where local governments have some control over the tax base. The NGA prefers moving toward at least a uniform tax base in each state, but the NCSL suggests allowing current policies to continue. Of course, if the base issue is left unchanged, it becomes a focal point for remote vendors that oppose complying with the use tax. In spite of the negative effect this would have on the success of simplification, many on the state and local government side oppose policy changes

---

24. National Retail Federation, "Congressional Voting Scoreboard: 106th Congress, 2nd Session" (2000); available from: <http://www.nrf.com>; last accessed 3 December 2003.

that would force them to give up the autonomy. However, as noted, the November 2002 agreement includes language that requires states to adopt a statewide uniform sales tax base, although state legislatures still have to agree to this.

### *Technology*

The final difficulty we note is associated with the use of technology. A proposal to develop and use technology to administer and comply with the use tax has support from remote vendors and tax administrators. Vendors see the use of technology as an important step toward easing their compliance burdens in areas such as audits and the handling of exemptions. However, one of the issues around the development of technology demonstrates the problem that states face. During the mid- and late-1990s, proposals were made to use technology to lead the effort to simplify use tax compliance. The proposed technology was to be used to monitor sales made by remote vendors and would have identified the taxability of the products purchased as well as the point of purchase or location of the buyer. But rather than helping resolve the problem, the discussions of technology sidetracked the progress that had been made. Although difficult to verify, it appears that some groups and individuals who have publicly opposed collecting the use tax suggested that the compliance technology would be an invasion of customer privacy. These critics had a point, because the technology would allow an agent of the government to have access to a detailed record of the purchases a consumer made. Newt Gingrich<sup>25</sup> made the following point: "Protecting consumer privacy is best accomplished by making the federal ban on discriminatory e-commerce taxes permanent. Any effort by government to control the Internet will inevitably require invasive monitoring and should be considered an assault not only on the medium but also on business and personal privacy" (p. 3).<sup>26</sup>

### *Summary*

Based on the concerns of state and local governments about revenue loss, unequal treatment of traditional and remote sellers, and the difficulty of complying with the sales and use tax, but tempered by the political and practical issues noted in this section, we sense that the states that adopted the SSTP agreement in November of 2002 are inclined to adopt many of the specified changes to their sales and use tax structures, and this will result in a simpler system. However, given the issues discussed in this section, we

---

25. Newt Gingrich, "Hands Off the Internet," *Washington Times*, 11 February 2000.

26. Grover Norquist, a lobbyist funded by the Internet firms, wrote the following, "The proposal put forth by the National Governors Association, which would enlist 'trusted third parties' to serve as interstate tax collectors, provided a prime example of how state and local politicians will sacrifice taxpayers' privacy in their quest for higher taxes." See Grover Norquist, "Privacy and Tax: Perspectives of Americans for Tax Reform," available from: <http://www.netcaucus.org>, no date; last accessed 3 December 2003.

seriously question whether the changes will be as substantial as many of the remote retailers and leaders of the SSTP desire.

## VOLUNTARY COMPLIANCE

The second issue we address is whether remote vendors will voluntarily collect the sales tax if a simplified sales and use tax system is put in place. Several individuals associated with the SSTP were motivated to undertake this effort by their belief or assumption that if the sales and use tax structures are simplified, then remote vendors would “voluntarily” collect and remit the sales tax. Under this view, vendors would choose to collect the sales tax if it were to their commercial advantage. To explore this proposition, we first consider the issue on theoretical and observed behavioral grounds and then turn to financial factors. In the next section, we consider this issue using a simulation model. Despite the political and practical issues we noted in the previous section, we will assume for the sake of argument that the SSTP process will result in a simplified sales and use tax system—even with the adoption of the SSTP agreement in November, we still consider the assumption of a simplified sales and use tax system a heroic one.

### *Theory and Observed Behavior*

*Tax clubs.* For a variety of reasons, there are doubts that voluntary collection of sales tax by remote vendors is a realistic possibility. The SSTP essentially asks remote vendors to voluntarily join in a collective with the states to comply with the use tax. Collective behavior does occur, but experience teaches a number of important lessons about the success of collective groups. Olson identifies a series of conditions that will undermine voluntary group cohesion. Many of Olson’s conditions apply to the current situation with use tax compliance.<sup>27</sup> Most notably, a challenge to voluntary compliance occurs when costs are easy to find but benefits are hard to identify. Thus, the question is whether “tax clubs” comprised of use tax compliers will develop.

The costs to the firms that are created by complying with the use tax are not immaterial. As noted earlier, compliance costs have been estimated to be as high as 3 percent and perhaps double that amount for vendors operating in multiple taxing jurisdictions. The cost is much higher in the case of purchases that are made with credit cards or checks, or result in bad debts for the firm. These costs are easy to identify, and they affect the financial health and long-run viability of a firm.

Conversely, the benefits to the firm for collecting the tax are difficult to identify. The remote vendor cannot point to better police or fire services provided by the revenues from the collected tax because remote vendors are unlikely to benefit directly from any expenditure. Vendors will also not be able to identify lower overall tax rates as a result of collecting and remitting the use tax. The result is a situation of measurable and direct costs

---

27. Mancur Olson, *Logic of Collective Action* (Cambridge, MA: Harvard University Press, 1971).

being weighed against diverse benefits that are generally not identifiable. And thus the incentives appear to run counter to participating in such a club.

A further dynamic suggests that if a sufficient number of firms comply with the use tax, the political and revenue pressures to mandate compliance diminish. Noncomplying vendors feel less pressure to comply and thus benefit from the compliance of others. Thus, vendors acting as free riders may undermine voluntary compliance with the use tax. The problem of free riders may not be a fatal flaw, but it does raise serious concerns regarding the likelihood of voluntary compliance.

The industrial organization literature suggests that with voluntary agreements, the opportunities and incentives to renege on agreements between self-interested principles and agents in a relationship can overwhelm either party. Klein, Crawford, and Alchian<sup>28</sup> argue that incentives to take advantage of other parties are so strong that firms often vertically integrate, even at the cost of efficiency, to avoid the unfavorable outcomes of relying on contractual relationships. In general, agency theory suggests that policy makers and tax administrators should be wary about any assumption that remote vendors will represent the state and collect the sales and use tax when they are not compelled to do so or when it is not in their self-interest to do so.

This does not mean firms will never comply with a request to voluntarily contribute to society. In fact, there is substantial evidence of corporate social responsibility.<sup>29</sup> This type of behavior is also observed at the individual level. It is not uncommon to find people who contribute to the good of an organization or association on a purely voluntary basis. Religious organizations, voluntary fire departments, and boys and girls clubs are among many examples. Such behavior suggests that individuals receive some benefit from participation in the voluntary organization. Of course, finding similar individual benefits from sales and use tax compliance is much harder to do. There are also situations in which groups participate in programs that benefit the community, even though they are only partially compensated for their activities. A real-world example is the role of voluntary compliance, or self-reporting, on environmental issues that are associated with violations of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).<sup>30</sup> Thus, it would appear that, as with income tax compliance rates, theory would predict lower voluntary compliance rates than would be suggested by behavioral observations in other contexts.

*Political acceptability of tax avoidance.* Convention plays an important role in society. Informal relationships and expectations that develop within and among organizations are used to minimize transaction costs. Convention is also important in public activities. For example, most adults have a sense of the “appropriate” behavior at a high school or college soccer game. In the context of the use tax, a convention to collect the use tax is not part of the relationship between remote vendors and public entities. More to the point, the current convention seems to be to do everything possible to avoid complying with the tax.

---

28. Benjamin Klein, Robert G. Crawford, and Armen A. Alchian, “Vertical Integration, Appropriable Rents and the Competitive Contracting Process,” *Journal of Law and Economics* 21, no. 3 (1978): 297–326.

29. Edwin W. Tucker and Jan W. Henkel, *The Legal and Ethical Environment of Business* (Homewood, IL: Irwin, 1992).

30. Louis Kaplow and Steven Shavell, “Optimal Law Enforcement with Self-Reporting of Behavior,” *The Journal of Political Economy* 102, no. 3 (1994): 583–606.

Reinforcing this attitude is the prevailing and strong political strategy in the United States of opposing existing tax levels and proposing reductions in taxes. It is an uncommon candidate who runs a political campaign at any level of government on the basis that if elected he or she will increase taxes. Not only are tax bases and rates attacked, attacks are mounted against institutions and individuals who have the responsibility to administer tax systems. In the past several national elections, a number of prominent political figures—Robert Dole, Steve Forbes, Ross Perot, and Pat Buchanan—have demonized the Internal Revenue Service.<sup>31</sup> One outcome of such behavior is to undermine the ability of the IRS to collect taxes.<sup>32</sup>

These attitudes are common in much of the debate over the collection of the use tax. We offer two examples of behavior that suggest the convention of not complying with the use tax is part of the strategy of remote sellers. First, remote vendor firms have fought a variety of administrative, political, and legal battles over nexus. As noted, they have prevailed in two extensive court battles with states to avoid collecting the use tax. It is hard to imagine that vendors would go to the expense of putting a case before the Supreme Court if they did not feel strongly about the use tax. It also suggests that having been part of the long conflict to avoid the burden of collecting the use tax, firms are unlikely to voluntarily give up the protection they have earned. In essence, states are asking nontraditional vendors to concede their nexus protection after the Supreme Court has clearly been on the side of the vendors. Further, giving up two sure victories may compromise future battles over other tax and nexus questions.

Second, it is easy to find evidence that even after nexus has been established, remote firms continue to try to avoid collecting the use tax. Many business firms adopt legal but extraordinary means to avoid paying state and federal corporate or business activity taxes. Firms create affiliate entities that allow the sheltering of taxable income obligations. These practices are now occurring around the use tax and operate as follows. A parent firm with nexus in a state creates an affiliate entity or subsidiary that has no physical presence in a state. By creating the affiliate separate from the parent, the firm avoids nexus for the affiliate. The affiliate completes sales transactions using indirect methods such as the mail, phone system, or the Internet, and the products are delivered by a third party not associated with either the parent or affiliate firm. The vendor not only shelters income but also its activities. Once the separate entity is created, the vendor argues that it has no responsibility to collect the use tax that is legally due from the consumer. Examples of both remote and main street vendors employing this practice are easy to find: Dell, Gateway, Wal-Mart, Saks Fifth Avenue, Borders, Barnes and Noble, and Nordstrom's.

The legal issues around use tax nexus for this form of organization are evolving. Cases in state courts in Tennessee and Illinois have ruled that such affiliate entities are responsible

---

31. R. Michael Alvarez and John Brehm, "Speaking in Two Voices: American Equivocation about the Internal Revenue Service," *American Journal of Political Science* 42, no. 2 (1998): 418–452.

32. There is evidence of a substantial underground economy in the United States that is at least partly motivated by the desire to avoid paying taxes. See Young H. Jung, Arthur Snow, and Gregory Trandel, "Tax Evasion and the Size of the Underground Economy," *Journal of Public Economics* 54, no. 3 (1994): 391–402.

for collecting the use tax. However, as Frieden<sup>33</sup> notes, in both of these cases, nexus was established because of business practices unrelated to the practice of creating affiliate entities, for example, in-state solicitation by the parent firm and visits by out-of-state officers to the affiliate entity. In a series of other state cases from Ohio, Pennsylvania, California, and Connecticut, the courts have validated the concept so that affiliate entities do not have a responsibility to comply with requests to collect use taxes. At the present time, the U.S. Supreme Court has not directly responded to any of the state use tax cases.

Running somewhat counter to the evidence presented above is the recent action of several national firms. These firms have indicated through a spokesperson that they have negotiated an agreement with several states and will start complying with the use tax. This action would suggest that the convention of noncompliance was changing, except for the fact that those who have agreed to comply have asked to remain anonymous and that their behavior may well be motivated by self-interest.

*Summary.* It seems clear that based on consideration of theoretical, political, and historical grounds many, if not most, firms are unlikely to agree to voluntary compliance in the current sales and use tax environment. Thus, if states are to overcome this inertia and secure broad-based cooperation from firms, they must design the voluntary system with great care, and they must provide firms with substantial financial incentives to participate. We turn now to a discussion of the financial implications of the SSTP for the voluntary collection of use taxes.

### *Financial Aspects*

In this section, we consider three overlapping financial considerations important to businesses: the cost of doing business, sales and market share, and the degree of future uncertainty. While all businesses are concerned about these three factors, once each factor is disaggregated into its component parts, it becomes clear that not all firms will view voluntary compliance from the same perspective. To make this point more clearly, we consider each factor. We discuss the financial implications of compliance under the current sales and use tax system and how the financial situation might be changed if SSTP proposals are implemented.

*Impact on the cost of doing business.* As of July 2002, Wal-Mart, Inc. reported having more than 3,300 retail facilities in the United States, including 3,172 outlets in locations that impose a sales tax. With the differences in tax base definitions and potentially 377 different sales tax rates, it seems clear that the cost of compliance is substantial for firms such as Wal-Mart. Compliance with sales tax requirements influences the cost of doing business in potentially four ways:

1. Information and collection costs. There are obvious costs associated with understanding legal requirements, implementing a tax collection system, and reporting and remitting the tax. Large firms with nexus in multiple states already have to bear the cost of monitoring changes in tax law, tax base, and tax rates. Thus, the additional costs of collecting use taxes for these firms, while positive, are likely to be modest. If the current

---

33. Karl Frieden, *Cybertaxation: The Taxation of E-Commerce* (Chicago: CCH, Inc., 2000).

system were simplified, both through reducing the number of rates and through more consistent uniform definitions of goods and services, large firms such as Wal-Mart would experience lower compliance costs, including the additional cost of collecting use taxes. Other firms, however, are likely to experience substantial increases in compliance costs by voluntarily collecting the use tax. This is particularly true for small Internet firms that sell across the country.

2. Audits. Tax audits require allowing government representatives to have access to sensitive financial information and strategic processes, are expensive and time-consuming, and impose a significant burden on businesses.<sup>34</sup> Sales and use tax audits can be conducted by individual states, the MTC, and even by local governments that might be concerned they are not getting their appropriate share of revenue from a tax. At least six states (Alabama, Alaska, Arizona, Colorado, Mississippi, and Louisiana) have active audit practices by local governments. There is enough demand for audit services by local governments that contract audit firms are emerging that claim to serve hundreds of local governments. When states conduct audits of the general sales tax, they routinely examine both the sales and use portion of the tax. For example, data reported by Murray that he obtained via a random examination of sales and use accounts maintained by the Tennessee Department of Revenue indicate that the presence of a use tax liability is extremely common among firms, but less than for the sales tax.<sup>35</sup> Murray also notes that the opportunity to avoid full compliance with the sales tax is enhanced by firms taking advantage of use tax complexities. The impact on the compliance costs for firms can be substantial. Wal-Mart, for example, has in excess of 300 stores audited each year and has approximately 120 open audits going on during a normal year.<sup>36</sup>

Sales and use tax audits require the storage and retrieval of information on thousands of transactions that are “consummated” in thousands of taxing jurisdictions. Large and small firms that engage in multistate B2B transactions are asked to verify that they have paid the use tax that is due. The audit can also provide information about firms that purchased goods sold by the firm being audited. This information can eventually be used to see whether the purchasing firm has paid the use tax to the appropriate taxing jurisdictions. Thus, in addition to raising issues of use tax compliance for the firm being audited, the audit also has implications for firms doing business with the audited firm. It takes little imagination to conclude that a firm that is audited because of the activity of a supplier is less likely to continue to use the firm that “triggered” the audit.

A system that reduces a firm’s audit costs will reduce the cost of doing business for that firm. If participation in a voluntary program subjected a firm to additional audits, a firm is unlikely to participate. However, if participation reduced the number of audits faced by a firm such as Wal-Mart from over a hundred to fewer than 50 each year, that firm would have an incentive to participate in the program.

---

34. James Andreoni, Brian Erard, and Jonathan Feinstein, “Tax Compliance,” *Journal of Economic Literature* 36, no. 2 (1998): 818–860.

35. Matthew N. Murray, “Sales Tax Compliance and Audit Selection,” *National Tax Journal* 48, no. 4 (1995): 515–530.

36. Personal conversation with Warren Townsend, Director of Sales, Use and Product Tax, Wal-Mart Stores, Inc., 2003.

Offering a firm the potential of latitude with respect to the frequency and extent of audits is an incentive that firms should find attractive. Several proposals have been raised under which firms that voluntarily collect the use tax would be subject to fewer audits of sales and use tax accounts. Audit protection would likely be driven by a firm's commitment to have its use tax compliance system validated by a state revenue department. If a firm had its own compliance system certified, or engaged an outside certified compliance company, it would be protected from audit exposure. Any audit would be conducted at the compliance firm, and discrepancies, including penalties and interests, would be an issue for the outside firm.

Because a use tax audit can create issues for a vendor's customers, a program that protects the vendor from audit would also offer some insurance to the clients. This protection might even become part of a marketing ploy vendors exploit as they sell products to out-of-state customers.

3. Cost of tax collection. Currently, 25 states allow firms to keep a portion of the sales tax they collect. These vendor discounts range from one half of 1 percent of the taxes collected to 3 percent, although many states do not extend the discounts to use tax collections. But, as noted above, this may not cover a firm's cost of collecting sales taxes. Part of the SSTP process is to develop a compensation package for vendors that choose to comply with the request to collect the use tax. In fact, the SSTP has developed a request for a study to estimate the cost of compliance associated with the sales and use tax.<sup>37</sup> It is anticipated that the results from the study will be used to develop a compensation structure for firms that collect the use tax.

If the level of vendor compensation when coupled with reductions in audit exposure and simplification is sufficiently large, firms may be encouraged to voluntarily collect use taxes.

The total collection costs for a particular firm will depend on the interaction of several factors:

- The change in sales volume resulting from a tax-induced price increase;
- The profit margin enjoyed by the firm;
- The sales tax rate(s);
- The cost of collecting the tax; and
- The proportion of collected tax the firm is allowed to retain.

An examination of these factors is presented below.

4. Nexus-related issues. There are two components of a simplified system related to the concept of nexus that could have an impact on the cost of doing business for some firms, though it is unlikely that they are as important as the three aspects discussed already. First, the status of nexus for some firms may be ambiguous, and the firm may be facing extended legal uncertainty and potential liability for past taxes. If the states in question offered such a firm amnesty for back taxes due as part of any agreement to join in the voluntary program, the firm may see some incentive to participate.

Second, firms may conclude that establishing a physical presence or nexus in a state is an important element in the marketing strategy of the firm. Nexus could create a number

---

37. The contract for this analysis has been awarded, but to date no funding has been provided by the SSTP participating states.

of advantages. For example, nexus would allow the development of traditional stores to handle returns and service issues (a serious concern for e-commerce involving billions of dollars in merchandise and resources)<sup>38</sup> or allow customers to come in and compare products. It may also mean that representatives of the firm are able to visit a state to solicit business and deal with service issues, or that the e-commerce side of a firm may decide it is to their advantage to use the retail location of the parent company to help market the products they sell. The firm may also find it is easier to use the states' legal system to enforce contracts. It may be that these benefits from establishing nexus could offset compliance costs that are sufficiently lowered by the SSTP.

*Impact on sales and market share.* Perhaps the most significant cost a vendor might encounter if they collect the use tax is a reduction in sales. Goods and services found in the shaded area of Figure 1 are ones for which we expect to see e-commerce sales and distribution models succeed. Because there is a modest requirement for fixed investment, it is reasonable to assume that a number of firms will enter the market to sell the goods found in the shaded area of Figure 1. Because goods represented by the shaded area are relatively uniform across vendors, price is a very important factor, and thus even a small price increase could undermine the competitive position of a firm. Thus, voluntary compliance with the use tax may not make sense for most of the firms using the e-commerce market place.

A factor that is making price even more important is the growing use of third-party vendors on the Internet. More and more markets have developed an electronic search engine or e-commerce *bots* that provide consumers with information about price, quality, availability, shipping charges, and whether the use tax is collected.<sup>39</sup> Bots have been developed for virtually every field of consumer products and are now found in industrial B2B markets such as metals, computers, chemicals, and semiconductors. The Internet gives customers the means to examine products and services easily and compare prices if use taxes are being charged.

Evidence suggests that consumers are aware of the cost advantage of purchases when no use or sales tax is collected. Customers in several surveys replied that collection of a tax would detract from their use of the Internet to make a purchase. A survey conducted by the Center for E-Commerce at UCLA found that over 45 percent of the respondents indicated they would not complete a purchase if they were required to pay the sales tax.<sup>40</sup> Goolsbee,<sup>41</sup> using data from 1999, concluded that collecting the use tax could reduce sales by as much as 24 percent. He also reports that consumer use of the Internet is greater in states with higher sales and use tax rates.

38. Claire Saliba, "Solving Online Returns: More Automation Would Cut Costs," *E-Commerce Times*, available from: <http://www.ecommercetimes.com>, 10 May 2001; last accessed 3 December 2003.

39. Arie Segen, Judith Gebauer, and Frank Farber, "Internet-Based Electronic Markets," Hass School of Business, Working Paper 98-wp-1036, January 1999.

40. UCLA Center for Communication Policy, *The UCLA Internet Report: Surveying the Digital Future*, available from: <http://www.ccp.ucla.edu>, 2001; last accessed 3 December 2003.

41. Austan Goolsbee, "In a World without Borders: The Impact of Taxes on Internet Commerce," in *The Internet Upheaval: Raising Questions, Seeking Answers in Communications Policy*, eds. Ingo Vogelsang and Benjamin M. Compaine (Cambridge and London: MIT Press, 2000), 29-46.